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In the

Supreme Court of The United States

October Term, 1964

No. 329

CHARLES P. HASBROOK and
MARCIA B. HASBROOK,

Petitioners

vs.

UNITED STATES OF AMERICA,

Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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PETITION FOR WRIT OF CERTIORARI

The Petitioners pray that a Writ of Certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in the above case on April 14, 1965.

OPINIONS BELOW

The opinion of the District Court for the District of Vermont, dated August 7, 1964, is not reported. The opinion of the Court of Appeals for the Second Circuit is reported at 343 Fed 2d 811. Both opinions are appended to this Petition in the Appendix.

JURISDICTION

The judgment of the Court of Appeals for the Second Circuit was made and entered on April 14, 1965. The jurisdiction of this Court is invoked under 28 USCA Section 1254(1).

QUESTION PRESENTED

This was an action to recover an alleged overpayment of income taxes for 1957 and arises out of the treatment by the Commissioner of Internal Revenue of a payment to one of the plaintiffs,

Mr. Charles P. Hasbrook, by one corporation for the preferred stock of another corporation as constituting the distribution of a constructive dividend to that plaintiff.

The question presented is whether the payment for the plaintiff's preferred stock constituted a constructive dividend.

STATUTES INVOLVED

The applicable sections of the Internal Revenue Code of 1954 are Section 302(a) (26 USC Section 302(a)) Section 302(b)(1) (26 USC Section 302(b)(1)) and 304(a)(1) (26 USC Section 304(a)(1)) which provide as follows:

> "Sec. 302. DISTRIBUTIONS IN REDEMPTION OF STOCK.
>
> (a) General Rule.—If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.
>
> (b) Redemptions Treated as Exchanges.—
>
> (1) Redemptions not equivalent to dividends.—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.
>
> Sec. 304. REDEMPTION THROUGH USE OF RELATED CORPORATIONS.
>
> (a) Treatment of Certain Stock Purchases.—
>
> (1) Acquisition by related corporation (other than subsidiary).—For purposes of Sections 302 and 303, if—
>
> (A) One or more persons are in control of each of two corporations, and
>
> (B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control, then (unless paragraph (2) applies), such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. In any such case, the stock so acquired shall be treated as having been transferred by the person from whom acquired, and as having been received by the corporation acquiring it, as a contribution to the capital of such corporation."

STATEMENT OF THE CASE

Since 1938 the plaintiff (that is, Mr. Charles P. Hasbrook whose wife is a party only because they filed a joint income tax return) owned and operated a radio station in Burlington, Vermont. In 1954, he obtained a license for a television station and organized a new corporation to which the assets of the radio business were transferred. The television corporation was named Mt. Mansfield Television, Inc. and the radio corporation was named WCAX Radio Corporation, Inc.

The plaintiff was the majority stockholder of both corporations, but the stockholders of the two corporations were substantially different.

The television corporation had both common and preferred stock. In 1957, 270 shares of the preferred stock of the television corporation were owned by the plaintiff and 130 shares were owned by Mr. Stuart T. Martin. The remaining six hundred shares of preferred stock were owned by others. The Plaintiff owned 598 of the 1,000 shares of the common stock of the Television Corporation.

The Radio Corporation had 100 shares of common stock only and the plaintiff owned all except two qualifying shares.

The studios of both corporations were in Burlington, Vermont, but at different locations. Records and news departments for both were kept at the Radio Station; art and advertising departments for both were in the Television Station. It was necessary to move personnel back and forth between the two locations continuously.

A new building was needed in order to bring the two businesses together in one location and a builder was found who would construct the building at a cost of $130,000.00 and lease it to the corporation.

The builder was able to provide $100,000.00 of the cost of the building and $30,000.00 of additional financing was needed.

The Television Corporation had then been in business for less than three years. It had large debts and operating deficits and it could not itself make the $30,000.00 loan, nor could it obtain the loan directly from the lending institutions which were consulted.

On the other hand, the Radio Corporation although it had been in business for nearly twenty years, and was financially stronger

than Television, could not by itself make the loan nor obtain a loan of this size either. A local bank suggested a procedure which would combine the borrowing power of both corporations without directly encumbering Television and it was this procedure by which the additional financing was provided. The Plaintiff and Mr. Martin would sell their 400 shares of preferred stock of the Television Corporation to the Radio Corporation for $40,000.00; The Radio Corporation would pledge this stock with the Bank for a $24,000.00 loan; the bank would lend an additional $16,000.00 to the Radio Corporation on an unsecured note, thus providing the Radio Corporation with $40,000.00 to pay the plaintiff and Mr. Martin. The plaintiff and Mr. Martin would loan $26,000.00 to the Television Corporation, and the additional $4,000.00 would be loaned by others.

This transaction was accomplished in 1957. The amount borrowed from the bank exceeded the $30,000.00 required in the expectation that the cost of the building would exceed the estimate.

The builder constructed the building and leased it to the Television Corporation and it was thereafter used by both corporations.

The loans to the Television Corporation and to the Radio Corporation have been repaid and the loan to the builder is being repaid in monthly installments.

Between 1959 and 1961 the Television Corporation redeemed all of its preferred stock, paying a premium of $2.00 a share.

The plaintiff, in 1957, received $100.00 a share for the preferred stock, which was exactly what he had paid for it.

The officers of the corporations knew of no way to provide for the financing of the building other than the way which was adopted.

The Commissioner of Internal Revenue assessed a tax deficiency against the plaintiff for the year 1957 on the claim that he had received a constructive dividend from the sale of the preferred stock of the Television Corporation in the full amount of the purchase price paid for the stock by the Radio Corporation.

The plaintiffs paid the assessment and filed a claim for refund of the payment, which was denied.

Jurisdiction of the District Court was invoked under 28 USC Section 1346(1).

REASONS FOR GRANTING THE WRIT

IRC Section 304(a)(1) provides that if one or more persons are in control of each of two corporations and one of the corporations acquires stock in the other corporation from such person in return for property, then such property shall be treated as a distribution in redemption of stock of the corporation acquiring such stock for purposes of section 302, and section 302(b)(1) provides that a redemption of stock by a corporation will be treated as an exchange, giving rise to capital gain or loss, if any one of four tests is met. If none of the four tests is met the transaction is not treated as an exchange but as the distribution of a dividend resulting in ordinary income.

The test under IRC Section 302 which has application here provides that a redemption of stock will be treated as an exchange resulting in capital gain or loss if it is not essentially equivalent to a dividend. IRC Section 302(b)(1).

The various courts of appeal are in disagreement as to the criteria for determining whether a redemption is "essentially equivalent" to a dividend within the meaning of IRC Section 302 (b)(1).

There is a conflict among the circuits as to whether and to what extent the business purpose of a transaction will be considered as a factor.

The Court of Appeals for the Second Circuit in this case held that under that section the business purpose of a transaction is irrelevant, and that the "net effect" of the transaction is determinative.

The court relied upon its decision in *Northup* v. *U. S.* (CA-2, 1957), 240 Fed 2d 304, where it held that the statute ". . . requires an examination of the net effect of the transaction as a whole, not an examination of the motives or purposes that prompted it." At Page 307. The issue was held to be one of law only.

The Court of Appeals also cited its decision in *McGinty* v. *Commissioner* (CA-2, 1963), 325 Fed 2d 820, where the Court stated, "Many courts also gave weight to the question whether there was a genuine corporate business purpose for the transaction. However, we have minimized the importance of this factor. . ." At Pages 821-822.

The Court of Appeals in the third circuit has adopted the same test as that in the second circuit. It stated in *Kessner* v. *Commissioner* (CA-3, 1957), 248 Fed 2d 943, 944 as follows:

> "The taxpayers contend that the Tax Court's finding of dividend equivalence is erroneous because, say they, there was a bona fide business purpose for both the issuance of the preferred stock and for its redemption and that the existence of such a purpose invalidates the Tax Court's ultimate finding.
>
> The argument is unsound. It is the effect of the redemption, rather than the purpose which actuated it, which controls the determination of dividend equivalence."

On the other hand, in the first, seventh, ninth and tenth circuits it is held that the question whether a distribution in redemption is essentially equivalent to a dividend is a question of fact, depending upon all of the circumstances of each case, including the circumstance whether there was some legitimate business purpose for the redemption. *Keefe* v. Cote (CA-1, 1954), 213 Fed 2d 651, 657; *Commissioner* v. *Snite* (CA-7, 1949), 177 Fed 2d 819, 823; *Earle* v. *Woodlaw* (CA-9, 1957), 245 Fed 2d 119, 129; *Jones* v. *Griffin* (CA-10, 1954), 216 Fed 2d 885, 687.

The application of the statutory test whether a redemption is essentially equivalent to a dividend has been said to be one of the most complex and elusive problems in the tax law. 2 Rabkin & Johnson, Federal Income, Gift and Estate Taxation, Section 24.02(1). The courts have referred to the problem as "exasperating," "vexing," and "nightmarish." Thomas R. Moore, "Dividend Equivalency in Taxation of Distributions in Redemption of Stock," Tax Law Review, March, 1964, page 249.

In the instant case, there was a business purpose for the stock transaction which was carried out. The Commissioner did not contend otherwise, but insisted that in the Court of Appeals for the second circuit that fact was irrelevant.

The Internal Revenue Code should be as consistently applied as possible in all parts of the country. The construction of the Code should not be left to depend upon the judicial circuit in which the action in which it is construed is brought. The question whether an undisputed corporate purpose for a transaction such as is involved in this case is material to the tax effect of the transaction should be resolved for the benefit of the public and of the government alike.

CONCLUSION

As a matter of law the sale of preferred stock of one corporation, which was purchased by the holder for cash, to another corporation, whose ownership is substantially different, the sale being made at the shareholder's purchase price and for a legitimate business reason, cannot properly be considered to have the net effect of a dividend within the meaning of Section 302(b).

For the reasons set forth above, it is respectfully submitted that this Petition for a Writ of Certiorari should be granted.

CHARLES D. POST
Counsel for Petitioner

APPENDIX

UNITED STATES COURT OF APPEALS

For the Second Circuit

No. 343—September Term, 1964.
(Argued February 18, 1965 Decided April 14, 1965.)

Docket No. 29351

CHARLES P. HASBROOK and MARCIA B. HASBROOK,
Plaintiffs-Appellants,

v.

UNITED STATES OF AMERICA,
Defendant-Appellee.

Before:

WATERMAN, FRIENDLY and HAYS,
Circuit Judges.

Appeal from a judgment of the United States District Court for the District of Vermont, Ernest W. Gibson, Judge, dismissing taxpayer's claim for refund, on the ground that purchase by one corporation controlled by taxpayer of his shares of preferred stock of another controlled corporation was essentially equivalent to a dividend under Sections 302 and 304 of the Internal Revenue Code of 1954.

Affirmed.

A. PEARLEY FEEN, Burlington, Vermont, *for Appellant.*

Jonathan S. Cohen, Attorney, Department of Justice, Washington, D. C. (Louis F. Oberdorfer, Assistant Attorney General, Lee A. Jackson and David O. Walter, Attorneys, Department of Justice, Washington, D. C., and Joseph F. Radigan, U. S. Attorney for the District of Vermont, of counsel), *for Appellee.*

HAYS, Circuit Judge:

The taxpayer (Marcia B. Hasbrook is a party only because she and her husband filed a joint return) brought an action in the district court for refund of taxes for the year 1957 paid under a deficiency assessment of the Commissioner of Internal Revenue. The Commissioner claimed that $27,000 received by the taxpayer from one of two brother-sister corporations controlled by him, in exchange for 270 shares of preferred stock of the other corporation, was a corporate distribution "essentially equivalent to a dividend" under Sections 302(b)(1) and 304(a)(1) of the Internal Revenue Code of 1954. The district court agreed and dismissed the taxpayer's complaint except for a matter not here relevant. We affirm.

The facts in this case are undisputed.

WCAX Radio, Inc. (Radio), had one hundred shares of common stock of which taxpayer owned all except two qualifying shares. Radio's books as of December 31, 1957, showed an earned surplus of $28,678.51, and $98,027.81 of undistributed earnings and profits in its common stock (or capital investment) account. Radio had never distributed any dividends.

In Mt. Mansfield Television, Inc. (TV), taxpayer owned 598 of the 1,000 shares of voting common stock and thus had voting control. He also owned 270 shares of $100 par preferred stock; his stepson Martin owned 130 such shares; and others owned the remaining 600 of the total 1,000 shares of TV preferred.

The Radio and TV corporations had been separately incorporated in 1954, but their operations in radio and TV broadcasting in Burlington, Vermont, were necessarily intertwined. A new building was needed in order to improve operations and a builder was found to construct for $130,000 a combined radio-TV building to be owned by the builder and leased by TV. The builder could raise $100,000 but needed $30,000 additional financing. It was agreed that this was to be loaned by TV. Since TV had large debts and an operating deficit, it could not itself make this $30,000 loan nor could it obtain a loan directly from the lending institutions which were consulted. A complicated series of transactions was suggested by a local bank: Hasbrook and Martin would sell their 400 shares of TV preferred to Radio for $40,000; Radio would pledge this stock with the bank for a $24,000 loan; the bank would lend an additional $16,000 to Radio on Hasbrook's unsecured note, thus providing Radio with $40,000 in

cash to pay Hasbrook and Martin; and Hasbrook and Martin would lend $26,000 to TV, which, together with $4,000 loaned by others, would provide TV with $30,000 in cash to finance the construction of the new building. This transaction was accomplished in 1957. Thereafter the builder constructed the building and leased it to TV. Radio and TV paid off their loans. Between 1959 and 1961 TV redeemed its shares of $100 par preferred at a premium of two dollars a share.

If Radio's payment to the taxpayer of $27,000 for his 270 shares of TV preferred was a dividend, then, under Section 301(c)(1) of the Code the distribution is to be included in gross income and is taxable as ordinary income. If the payment was not a dividend it was entitled to special tax treatment (Section 301 (c) (2), (3).

Since taxpayer controlled both TV and Radio the acquisition by Radio of the stock of TV is to be treated under Section 304(a)(1) as a redemption by Radio of its own stock. The proceeds of such a redemption are to be treated under Section 302(a) "as a distribution in part or full payment in exchange for the stock," if any one of four tests set forth in Section 302(b) applies to the redemption. Taxpayer claims that the redemption is covered by Section 302(b)(1) which provides that Section 302(a) "shall apply if the redemption is not essentially equivalent to a dividend."

We hold, however, that Section 302(b)(1) has no application because the distribution to taxpayer of the $27,000 was essentially equivalent to a dividend.

This court has recently stated that "the hallmarks of a dividend . . . are pro rata distribution of earnings and profits and no change in basic shareholder relationships." *Himmel* v. *Commissioner*, 338 F. 2d 815, 817 (1964).

Here the distribution came from Radio's earnings and profits. It was a pro rata distribution since any distribution to the sole owner of the corporation's stock is necessarily pro rata. The distribution effected "no change in basic shareholder relationships." Taxpayer continued after the distribution to hold exactly the same proportion of the common stock of TV and Radio which he had held before the distribution. As for the preferred stock of TV[1] he had actually parted with none of his 270 shares since after the transaction was accomplished he still held, for all practical pur-

poses, the same 270 shares through his ownership of the stock of Radio.[2] Realistically, then, the distribution resulted in no change in the pre-existing situation, except that taxpayer had in his own hands $27,000 which had formerly been in the earnings and profits of Radio. It seems clear to us, therefore, that the distribution was essentially equivalent to a dividend.

Taxpayer urges that the distribution should not be treated as a dividend because the transaction as a whole had a "business purpose."

This court has stated that the business purpose of a transaction is irrelevant in determining dividend equivalence, *Northup* v. *United States*, 240 F. 2d 304, 307 (2d Cir. 1957). See also *McGinty* v. *Commissioner*, 325 F. 2d 820, 821-22 (2d Cir. 1963). Here the character of the business purpose raises a further question. The taxpayer argues that the bank was willing to lend to Radio, rather than to TV directly, because of Radio's better credit rating. Similar arguments that certain redemption transactions were intended to improve a corporation's credit rating with outside institutions and that these transactions should therefore be held not equivalent to a dividend were rejected in *Kerr* v. *Commissioner*, 326 F. 2d 225, 231-32 (9th Cir.), cert. denied, 377 U. S. 963 (1964); *Bradbury* v. *Commissioner*, 298 F. 2d 111, 117-18 (1st Cir. 1962); and *United States* v. *Fewell*, 255 F. 2d 496, 499-500 (5th Cir. 1958). However the transaction might have been arranged to avoid the issue of dividend equivalence, it is plain that the taxpayer's purpose here was to utilize the high credit rating of Radio owing to its retention of earnings in order indirectly to effect a loan to TV. This is not, we believe, the sort of transaction that Congress intended to protect from the effects of dividend equivalence.

Affirmed.

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[1] In Sec. 304(b) (1), among the "special rules for application of subsection (a)," is a "rule for determinations under section 302(b)" which provides in part:

"In the case of any acquisition of stock to which subsection (a) of this section applies, determinations as to whether the acquisition is, by reason of section 302(b), to be treated as a distribution in part or full payment in exchange for the stock shall be made by reference to the stock of the issuing corporation."

Determination by reference to stock of the issuing corporation is clearly relevant to provisions of Sec. 302 other than Sec. 302(b) (1). To the extent that the special rule is applicable to Sec. 302(b) (1) it may be taken to refer to the test for dividend equivalence of "change in basic stockholder relationships." The amount which is a dividend is to be determined by reference to the "earnings and profits of the acquiring corporation." Sec. 304 (b) (2) (A).

[2] Taxpayer raises the point that Radio purchased the 130 preferred shares of TV belonging to Martin as well as the 270 shares belonging to taxpayer. The payment to taxpayer is not less a "dividend" because Martin also sold stock to Radio. The relevant consideration is the effect of the transaction as between the taxpayer and the acquiring corporation. See *Phelps* v. *Commissioner*, 247 F. 2d 156, 158-59 (9th Cir. 1957).

Moreover, the effect of the transfer was that when Radio purchased Martin's shares for $13,000 out of its earnings and profits, the shares became in reality the property of taxpayer through his ownership of the common stock of Radio. Surely this cannot be used as an argument against his being taxed on $27,000 out of the total of $40,000 paid out by Radio for the preferred stock.

UNITED STATES DISTRICT COURT

For the District of Vermont

CHARLES P. HASBROOK and MARCIA B. HASBROOK		CIVIL ACTION
vs.		No. 3767
UNITED STATES OF AMERICA		

STATEMENT OF THE CASE, FINDINGS OF FACT, CONCLUSIONS OF LAW AND JUDGMENT ORDER

STATEMENT OF THE CASE

This action was brought by Charles P. Hasbrook and his wife Marcia B. Hasbrook (hereinafter for simplicity called plaintiff) seeking a recovery of $18,576.31 paid by the plaintiff as a deficiency income tax with interest for the calendar year 1957. Said deficiency, together with interest thereon, was assessed against the plaintiff and on July 9, 1962 the plaintiff paid it to the District Director of Internal Revenue for the District of Vermont. On November 28, 1962 the plaintiff filed a claim for refund in the amount assessed. Plaintiff has since been notified of the disallowance of such claim and the instant action was timely commenced on July 10, 1963.

A trial by this Court was heard on May 13, 1964 at which time all parties were requested to submit to this Court memoranda of law and requests for findings of fact.

FINDINGS OF FACT

Upon consideration of the transcript of the trial, memoranda of law, and suggested findings of fact, I find the following facts:

1. Prior to 1954 plaintiff owned and operated WCAX Broadcasting Corporation, a radio station in Burlington, Vermont. On September 1, 1954, in order to facilitate the operation of a television station, WCAX Broadcasting Corporation spun off the assets and liabilities of the radio operation to a newly-formed corporation WCAX Radio, Inc. (hereinafter called Radio), in exchange for 100 shares of no par common stock. Among the assets transferred to Radio were undistributed earnings and profits total-

ling $98,027.81 which were included in Radio's common stock account. In addition, plaintiff retained ownership of 598 of 1,000 outstanding shares of WCAX Broadcasting Corporation's voting common stock, as well as 400 of 1,000 outstanding shares of WCAX Broadcasting Corporation's $100 par preferred stock. WCAX Broadcasting Corporation then changed its name to Mt. Mansfield Television, Inc. (hereinafter called Mt. Mansfield) and commenced the operation of television broadcasting. On October 22, 1955 plaintiff transferred 130 shares of preferred stock of Mt. Mansfield to Stuart T. Martin, the then vice-president and general manager of Mt. Mansfied. In summary, the stockholders of the two corporations were not identical but the majority stockholder of both corporations was the plaintiff and in 1957 at least 270 shares of the preferred stock of Mt. Mansfield were owned by the plaintiff and 130 preferred shares were owned by Mr. Martin.

2. The studios and offices of Radio and Mt. Mansfield were both in Burlington, but in different locations. (The records for both operations were kept at Radio and the news department for both was there. The art and advertising departments for both were at Mt. Mansfield). Due to the physical separation of the two corporations but the close working relationship which existed, in 1957 it became apparent that the existing decentralized facilities of these two corporations were outmoded and there was a vital need to bring the two businesses together in one location. Plaintiff began investigating the feasibility of acquiring a new building which would permit the economical operation of both Radio and Mt. Mansfield under one roof. Plaintiff located a builder, Thomas A. Farrell, who agreed to construct a new studio and office building to be built according to the plaintiff's specifications with the building to be owned by the builder and leased to Mt. Mansfield. Construction of this building required an investment on the part of the builder Mr. Farrell of $130,000. Of that amount Mr. Farrell was able to provide only $100,000 and thus $30,000 additional financing was required. Accordingly, it was agreed that Mt. Mansfield would loan the additional $30,000.

At this time Mt. Mansfield had been in business for less than three years and had an operating deficit of $13,000. It was then indebted in the amount of $154,000 of which amount $56,000 was owed to Radio. The matter of how Mt. Mansfield would raise the necessary $30,000 was discussed with several lending

institutions and various alternatives were considered for the financing.

3. Generally, the plan of financing agreed upon was that plaintiff and Mr. Martin sell their 400 preferred shares in Mt. Mansfield to Radio. Radio would use this stock to secure a $24,000 loan from the Chittenden Trust Company of Burlington. Chittenden Trust Company would also loan Radio $16,000 on a personal unsecured note from the plaintiff. Radio would then pay for its purchase of the 400 $100 par preferred shares of Mt. Mansfield stock from Mr. Martin and the plaintiff with the accumulated $40,000. Mr. Martin and the plaintiff would then loan Mt. Mansfield $26,000 of this amount towards its financing of Mr. Farrell. (The additional $4,000 required to equal the necessary $30,000 was loaned to Mt. Mansfield on personal unsecured notes by other shareholders of Mt. Mansfield.) Thus Mt. Mansfield possessed $30,000 which it lent to Mr. Farrell in return for a note and second mortgage on the new building.

Specifically, the financing was arranged as follows:

a. Plaintiff and Mr. Martin transferred 270 and 130 shares, respectively, of Mt. Mansfield $100 par preferred stock to Radio in exchange for $40,000. It is this particular transaction which is involved in this suit.

b. Radio obtained $24,000 from the Chittenden Trust Company in exchange for a note and security in the form of the 400 shares of Mt. Mansfield preferred stock. An additional $16,000 was obtained from the Chittenden Trust Company for Radio on a personal unsecured note of the plaintiff.

c. Plaintiff advanced $16,000 to Mt. Mansfield in exchange for an unsecured note, retaining $11,000 of the amount he received from Radio. Mr. Martin transferred $10,000 to Mt. Mansfield in exchange for an unsecured note, retaining $3,000 of the amount he received from Radio. The balance of $4,000 was advanced to Mt. Mansfield by minority shareholders in exchange for unsecured notes.

d. Mt. Mansfield advanced the loaned $30,000 to Mr. Farrell in exchange for a note and second mortgage.

4. Mr. Farrell completed the building and leased it to Mt. Mansfield and it was thereafter used by both Radio and Mt. Mansfield until the sale of Radio in 1963.

5. Mt. Mansfield has repaid the $30,000 loaned to it by the plaintiff, Mr. Martin and the other shareholders. Radio has repaid Chittenden Trust the $40,000 loaned to it on the strength of the 400 shares of Mt. Mansfield stock and the plaintiff's personal note and thus became the holder of 400 shares of Mt. Mansfield stock.

6. On December 31, 1957 Radio had an earned surplus of $28,678.51 in addition to undistributed earnings and profits retained in its common stock account. From the date of its incorporation in 1958 Radio made no distribution of dividends to its stockholders. During 1959, 1960 and 1961 Mt. Mansfield redeemed all of its shares of preferred stock, paying a premium of $2.00 per share and in this redemption Radio received its proportionate share for the shares of Mt. Mansfield stock which it held.

7. With the exception of two shares of stock, all of Radio's stock was held by the plaintiff until Radio was sold in 1963. As already mentioned, the plaintiff also held a controlling interest in Mt. Mansfield. The purchase of 270 shares of Mt. Mansfield stock by Radio did not change plaintiff's control in either corporation.

8. In his income tax return for 1957 the plaintiff failed to include as ordinary income the $27,000 which he received from Radio for his 270 shares of Mt. Mansfield preferred stock (the stock sold to Radio which it pledged as security to Chittenden Trust Company). Upon audit, this $27,000 was held to be includible in the plaintiff's income as a dividend by the District Director of Internal Revenue. He ruled it should have been included as ordinary income. As a result of this holding (and certain other adjustments not in issue here), the plaintiff paid additional income tax in the amount of $14,845.99, plus $3,745.66 in interest. A timely claim for refund of this amount was filed by the plaintiff which was denied by the Director and this action was then timely commenced on July 10, 1963.

CONCLUSIONS OF LAW

Although the facts in this case may appear involved due to the complicated financial arrangements, the basic question in this case is whether the sale by the plaintiff of his 270 shares of preferred stock of Mt. Mansfield to Radio, both corporations controlled by the plaintiff, was a redemption essentially equivalent to a dividend under the provisions of Section 302(b)(1) of the Internal Revenue Code of 1954.

All the parties to this action concede that Section 304 of the Internal Revenue Code is applicable to this case. In substance, it states that for the purposes of Section 302, if a person is in control of two corporations and one of the corporations acquires stock in the other corporation from the person in control in return for property of the acquiring corporation, then such property shall be treated as a distribution in redemption of the stock of the acquiring corporation. Section 304 does not of itself determine whether the redemption shall be treated as a dividend distribution or as a sale. By its opening clause, it provides that in those situations described within Section 304 the determination whether capital gain rates apply will be made under Section 302.

Section 302, *Distributions in Redemption of Stock* states:

> "(a) *General Rule.*—If a corporation redeems its stock (within the meaning of section 317(b), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock [and resulting in capital gain or loss to the seller].
>
> (b) *Redemptions treated as exchanges.*—
>
> (1) *Redemptions not equivalent to dividends.*—Subsection (a) shall apply if the redemption is not essentially equivalent to a dividend.
>
> . . . . . .
>
> . . . . . ."

If Section 302 is found to be inapplicable, then Section 301 applies and by Section 301(c) that portion of the distribution which is a dividend shall be included in gross income.

The question thus becomes whether the transaction between the plaintiff and Radio comes within the ambit of Section 302. If it does, then the plaintiff is entitled to recover; if it does not, then the plaintiff's complaint must be dismissed.

In order to come within the ambit of Section 302 the first test is that the transaction must be a redemption within the meaning of Section 317(b), a test which is conceded by all parties is met in this case. The second test in deciding whether a transaction is within the ambit of Section 302 is whether the transaction meets any one of four tests set forth in Section 302(b). If it does, then the redemption is to be treated as a distribution in exchange for stock and results in capital gain to which capital gain rates are applicable. However, even if the transaction is a redemption

under Section 317(b) but does not qualify under any of the tests of Section 302(b), then it is a redemption which is equivalent to a dividend and shall be included in gross income. See Section 301.

All parties concur that the tests set forth in paragraphs (2), (3) and (4) of Section 302(b) are inapplicable to this case. The question in its narrowest form thus becomes whether the redemption meets the test of Section 302(b)(1). If the redemption is not essentially equivalent to a dividend, it meets this test and Section 302(a) applies in its entirety; if the redemption is essentially equivalent to a dividend, the redemption fails to qualify and then Section 302(a) is inapplicable and Section 301 applies.

Plaintiff contends that the sale by the plaintiff of his preferred stock in Mt. Mansfield to Radio was prompted by a genuine business purpose and that purpose was accomplished by such sale. It argues that in light of the business purpose served and the result accomplished by the sale of the stock, there is no basis for treating the transaction as being essentially equivalent to a dividend. In other words, the plaintiff would have this Court apply the "business purpose" test in determining whether or not the redemption was essentially equivalent to a dividend.

The defendant Internal Revenue Service contends that the proper test to be utilized in determining whether a redemption is essentially equivalent to a dividend is by examining the "net effect" of the redemption and that in this examination the most important factor is whether the redemption significantly affected the interest which the seller-shareholder has in the acquiring corporation. In other words, if the shareholder ends up in the same position he would have if the acquiring corporation had declared and paid a dividend rather than purchasing stock of another corporation controlled by the same shareholder, then the transaction is essentially equivalent to a dividend and the test of Section 302(b)(1) is not met. Under the "net effect" test propounded by the Internal Revenue Service the business purpose and motive of the parties involved are irrelevant.

The source of Section 302(a) and (b) of the 1954 Internal Revenue Code is Section 115(c) and (g)(1) respectively of the 1939 Internal Revenue Code. The tests for what is "not essentially equivalent to a dividend" were first formulated under the 1939 Code. In enacting Section 302(b)(1) Congress intended that

the test utilized under the new section should be the same test utilized in interpreting and applying the same words in the 1939 Code. S. Rep. No. 1622, 83d Cong., 2d Sess., p. 234 (3 U.S.C. Cong. and Admin. News (1954) 4621, 4870).

The doctrine followed by the Second Circuit was laid down in *McGinty* v. *Commissioner*, 325 F.2d 820 (2d Cir. 1963). In construing this clause of Section 302(b)(1), it said:

> "The Committee Report indicates that the determinative question in considering whether a redemption is not essentially equivalent to a dividend is whether the transaction may be characterized as a sale of stock to the corporation, and the tests to be applied are, in general, those developed under section 115(g) of the 1939 Code. By far the most important of these tests was whether the redemption was substantially pro-rata—*i.e., did it significantly affect the interest which the redeeming shareholder has in the corporation.* We think this factor continues to be of greatest weight in interpreting §302(b)(1). . . . Many courts also gave weight to the question whether there was a genuine corporate business purpose for the transaction. However, we have minimized the importance of this factor in *Northup* v. *United States*, 2 Cir., 240 F.2d 304 (1957), and see little reason to accord more weight to it under the 1954 Code than under the predecessor statute." [Footnotes omitted, emphasis added.]

The test which has been stated by the Second Circuit is considered to be the "strict net effect" test and under this test the business motive and plans of the parties are irrelevant. See *Kerr* v. *Commissioner*, 326 F.2d 225 at 230 (9th Cir. 1964).

What little weight could be attributed to plaintiff's argument of "business motive and purpose" is negated by the fact that inasmuch as the plaintiff was the controlling shareholder of both Radio and Mt. Mansfield, he could himself just as easily have pledged the Mt. Mansfield stock as security to the Chittenden Trust Company without the necessity or involved arrangement of selling it to Radio and Radio then pledging it to the Chittenden Trust Company. Since this is true, the sale by the plaintiff to Radio appears superfluous to any business purpose or motive the plaintiff might have had.

When examining the facts in the instant case, it is clear that the plaintiff has remained in the same position he would have if Radio

had declared and paid a dividend in the amount which the plaintiff received for the stock of Mt. Mansfield. Plaintiff's stock ownership in Radio subsequent to the purchase by Radio remained the same. The "net effect" of the sale to Radio made no difference to plaintiff's position; it did not significantly affect the interest which plaintiff possessed in the corporation.

Accordingly, the transaction between the plaintiff and Radio is considered a redemption but this redemption is deemed to be essentially equivalent to a dividend and therefore the test of Section 302(b)(1) is not met—Section 302(a) is therefore applicable. As mentioned, in such a case Section 301 applies and the redemption must be treated as a dividend and included in gross income.

JUDGMENT ORDER

Wherefore, at the time of trial the defendant having conceded plaintiff's claim as stated in paragraph 6(b) of the complaint relating to constructive dividends to the plaintiff, and upon consideration of the merits of the remaining issue of whether the sale by the plaintiff to Radio was a redemption essentially equivalent to a dividend, IT IS HEREBY ORDERED that the Commissioner of Internal Revenue improperly held that certain withdrawals by plaintiff from his drawing account with Radio were constructive dividends and they shall consequently be re-assessed in accordance with the agreement reached by the parties.

That all other claims of the plaintiff are without merit and the complaint of the plaintiff, with the above noted exception, be and hereby is dismissed.

Judgment in favor of the defendant, except as noted, is hereby granted. No costs.

ERNEST W. GIBSON

Done at Brattleboro, in the District of Vermont, this 7th day of August, 1964.